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FISCAL IMPACT STATEMENT

LS 6282

BILL NUMBER: SB 19

NOTE PREPARED: Jan 18, 2008

BILL AMENDED: Jan 16, 2008

SUBJECT: Various Tax Matters.

FIRST AUTHOR: Sen. Kenley

FIRST SPONSOR:

BILL STATUS: CR Adopted - 1st House

FUNDS AFFECTED: X GENERAL
X DEDICATED
FEDERAL

IMPACT: State & Local

Summary of Legislation: (Amended) *Sales Tax on Flying Lessons* - This bill provides that a person taking flying lessons pays sales tax on the rental of the plane but not for the flight instructor's costs.

Sales Tax Returns - The bill requires sales tax returns to be filed on a monthly basis even if the taxpayer files using electronic funds transfer (EFT). It increases the sales tax filing threshold so that if the annual liability is less than \$1,000, the taxpayer files only an annual return (instead of a monthly, quarterly, or semiannual return).

Bad Debt Sales Tax Deduction - The bill specifies that the amount of a bad debt deduction from the Sales Tax that may be claimed by a purchaser of accounts receivable is the amount paid by the purchaser for those receivables (not their face value).

529 Education Savings Plan - The bill provides that if a taxpayer makes a nonqualified withdrawal from a college choice education plan and is a nonresident who has no current tax liability, the Department of State Revenue (DOR) shall bill the taxpayer for the amount of any tax credit to be recaptured.

Electronic Tax Filing - This bill imposes a penalty of \$50 per return (not to exceed \$25,000 per year) on a professional preparer who does not file individual income tax returns electronically and has filed more than 100 returns. It provides an "opt out" exception for individuals over 65 years of age who do not want their return filed electronically.

Income Tax Withholding - The bill requires wage withholding payments and estimated tax payments for nonresident aliens to be computed based on the application of not more than one personal exclusion. It

requires employers to report to the DOR the amount of withholdings attributable to local income taxes each time the employer remits to the department the tax that is withheld. The bill also requires an individual filing an estimated tax return to designate the portion of the estimated tax payment that represents state income tax liability and the portion of the estimated tax payment that represents local income tax liability. It provides that if an individual requests the payor of a distribution to withhold taxes from the distribution, the individual must designate the portion of the withheld amount that represents state income tax liability and the portion of the withheld amount that represents local income tax liability. This bill also requires the DOR and the Office of Management and Budget to develop certain reports and procedures to ensure that local option income taxes are accurately distributed.

Earned Income Tax Credit - This bill reduces the state Earned Income Tax Credit for partial year nonresidents who have taxable income in other states.

Financial Institutions Tax - For purposes of the financial institutions tax, the bill requires taxpayers to add back dividends paid to shareholders of a captive real estate investment trust.

Cigarette Tax - This bill requires a cigarette distributor to be current in all listed taxes before a distributor's license may be issued or renewed. It also requires cigarette tax payments via EFT if the distributor purchases the stamps on credit.

Tax Confidentiality - The bill permits the DOR to disclose information concerning taxpayers to state and local law enforcement officials in Indiana when used for official purposes and requested by the proper authorities.

Tax Penalties - This bill imposes a penalty on certain individuals for failure to file an income tax return. It provides that the penalties for bad checks issued to pay listed taxes also apply to payments made by credit card, debit card, and electronic payments.

Effective Date: (Amended) January 1, 2008 (retroactive); July 1, 2008; January 1, 2009.

Explanation of State Expenditures: (Revised) *Summary of Expenditures* - It is estimated that this bill will result in minimal administrative cost savings for the DOR. All of these provisions will require the DOR to amend forms, rules and procedures related to administration of the corporate and individual Adjusted Gross Income (AGI) taxes, the Sales Tax, the Financial Institutions Tax, and the Cigarette Tax. Although, it is estimated that these increased costs will be offset by the administrative costs savings resulting from provisions in the bill.

The provisions of the bill estimated to result in administrative cost savings are as follows:

- Sales Tax Returns;
- Earned Income Tax Credit;
- Electronic tax filing;
- Tax Penalties

The following provisions could result in an increase in administrative costs to the DOR.

- 529 Education Savings Plan;
- Income Tax Withholding;
- Tax Confidentiality

The remaining provisions of this bill, which were not mentioned above, are either indeterminable or have no fiscal impact. A more detailed discussion of the bill's provisions follows.

Sales Tax Returns - It is estimated that the DOR will realize an administrative cost savings due to the change in the bill requiring all retailers with a Sales Tax liability under \$1,000 in the previous calendar year to file returns annually. The administrative cost savings to the DOR is estimated to be from the decreased data entry and returns processing costs for annual returns versus monthly, quarterly, or semi-annual returns. It is estimated that over 25,000 retailers will be required to file annual returns rather than semi-annual, quarterly, or monthly returns.

The DOR reports that there are currently 60,000 returns filed on an annual bases, under 50 filed on a semi-annual basis, and approximately 25,000 filed on a quarterly basis. All of these retailers have less than \$900 of Sales Tax liability per calendar year. The bill would require all of these retailers to file on an annual basis. The bill would also require retailers with Sales Tax liability in the previous calendar year between \$900 and \$1,000 to file annually rather than monthly as required under current law. The number of files with liability between \$900 and \$1,000 per year is unknown.

Income Tax Withholding - The bill requires wage withholding payments and estimated tax payments for nonresident aliens to be computed based on the application of not more than one personal exclusion. It does not, however, restrict the number of personal exclusions that may be claimed on the taxpayer's final return for the taxable year. This bill requires employers to report to the Department of State Revenue (DOR) the amount of withholdings attributable to local option income taxes each time the employer makes a payment. Current statute only requires employers to report this amount with the employer's annual filing.

The bill also requires the DOR, in cooperation with the Office of Management and Budget (OMB), to develop reports and procedures to ensure the income taxes are accurately and properly distributed to each county.

Explanation of State Revenues: (Revised) *Sales Tax on Flying Lessons* - According to DOR, this provision codifies how these transactions are currently treated during the administration of the Sales Tax. Therefore, it is estimated that there will be no fiscal impact due to this provision.

Bad Debt Sales Tax Deduction - The DOR reports that this provision is a codification of how these bad debt deductions are currently administered, and therefore it is estimated this changes will have no fiscal impact. The bill provides that a purchaser of accounts receivable that later becomes uncollectible is entitled to deduct the price paid for the receivable not the face value of the receivable. Current law specifies that the deduction may not include interest and shall conform to Section 166 of the Internal Revenue Code, excluding the following:

- (1) financing charges;
- (2) sales or use taxes charged on the purchase price;
- (3) uncollectible amounts on property that remain in the possession of the seller until the full purchase price is paid;
- (4) expenses incurred in attempting to collect any debt; and
- (5) repossessed property.

Sales Tax Returns -This provision will cause a shift of Sales Tax revenues from FY 2009 to FY 2010. It is estimated that any possible interest lost from the funds being deposited at a later time will be offset by the

administrative cost savings to the DOR from the decreased data entry and return processing costs for annual returns versus monthly, quarterly, or semi-annual returns.

529 Education Savings Plan - The bill provides that if a taxpayer makes a nonqualified withdrawal from a college choice education plan and is a nonresident who has no current tax liability, the DOR shall bill the taxpayer for the amount of any tax credit to be recaptured. This provision should allow DOR to collect these credits sooner.

Financial Institutions Tax - The bill establishes an add back of deductions taken on a financial institution's federal income tax return for dividends paid to shareholders of a "captive real estate investment trust"(REIT). The amount of revenue that could potentially be captured due to the add back is indeterminable and dependent on the number of taxpayers currently utilizing captive REITs. Since the add back is effective beginning in 2009, the fiscal impact of this provision could commence in FY 2009 or FY 2010 depending upon its effect on quarterly estimated tax payments.

The bill defines a captive REIT as a corporation, a trust, or an association:

- (1) that is considered a REIT for federal income tax purposes under the Internal Revenue Code (IRC);
- (2) that is not regularly traded on an established securities market; and
- (3) in which more than 50% of the voting power, beneficial interests, or shares are owned or controlled, directly or constructively, by a single C-corporation.

Background: A REIT is a corporation, trust or association that acts as an investment agent specializing in real estate and real estate mortgages. Under the IRC a REIT, unlike an ordinary corporation, is entitled to claim a deduction for dividends paid to shareholders against their ordinary income and net capital gains. A REIT must meet certain requirements as to ownership and organization, source of income, investment of assets, and distribution of income to shareholders.

Electronic Tax Filing - This bill imposes a penalty of \$50 per return (not to exceed \$25,000 per year) on a professional preparer who does not file individual income tax returns electronically and has filed more than 100 returns. It provides an "opt out" exception for individuals over 65 years of age who do not want their return filed electronically.

Income Tax Withholding - The bill requires wage withholding payments and estimated tax payments for nonresident aliens to be computed based on the application of not more than one personal exclusion. The increase or decrease in exemptions claimed on nonresident aliens' final tax returns, and the associated dollar amount, is unknown. The fiscal issue is that of compliance and timing. State revenues may increase an indeterminable amount during the tax year due to withholding payments and estimated tax payments for nonresident aliens being computed based on the application of only one exemption. However, should nonresident aliens have more than one legitimate personal exemption, they may still be claimed on the taxpayer's final return. The result could be a potentially insignificant net impact on state revenue.

A scenario where state revenue may increase an indeterminable amount is if nonresident aliens do not file a final tax return or they are currently claiming more exemptions than allowed. This bill may create an incentive for compliance in filing a final tax return in order to be eligible for a tax refund. Since the new withholding requirement is effective beginning in tax year 2009, any fiscal impact would begin in FY 2010.

The new reporting requirements placed on the DOR and the OMB in addition to the new designation placed

on taxpayers in regard to the amount of state income tax liability and local income tax liability withheld as a portion of total withholdings would have no fiscal impact on state revenues.

Cigarette Tax - This bill requires a cigarette distributor to be current in all listed taxes before a distributor's license may be issued or renewed. According to DOR there are 120 cigarette distributors currently licensed in Indiana. This provision will only have an impact to the extent that more taxes are collected due to this license issuance and renewal requirement. The amount of any impact is indeterminable.

Earned Income Tax Credit - This bill reduces the state earned income tax credit for partial year nonresidents who have taxable income in other states, thereby increasing their state taxable income. It requires that a nonresident taxpayer multiply the value of the credit under current law by the percentage of their income taxable in Indiana. In 2005, 18,745 partial year nonresidents claimed the Earned Income Tax Credit on their tax returns. The average credit was approximately \$112 with a maximum credit of \$264, totaling \$2.1M. From 2000 to 2005, the total Earned Income Tax Credits claimed increased 25% on average annually. Similarly, the number of filers claiming the credit increased by 35% for the same time period.

Tax Penalties - This bill imposes a penalty on certain individuals for failure to file an income tax return. It provides that the penalties for bad checks issued to pay listed taxes also apply to payments made by credit card, debit card, and electronic payments.

Explanation of Local Expenditures:

Explanation of Local Revenues: (Revised) Some of this bill's provisions may impact taxable income. The extent to which counties imposing local option income taxes may experience an increase or decrease in revenue is indeterminable.

State Agencies Affected: Department of State Revenue; Office of Management and Budget.

Local Agencies Affected: Counties with a local option income tax.

Information Sources: OFMA Income Tax Databases, 2000-2005; Tom Conley, Department of State Revenue, 317-232-2107; Bureau of Labor Statistics; Urban Institute; Internal Revenue Service; U.S. Census.

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